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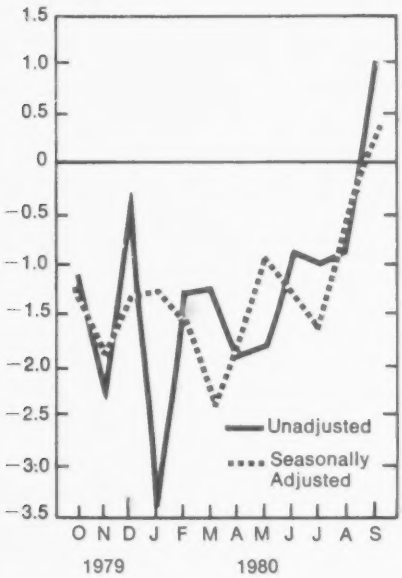
Japan's Recession Accompanied By Payments Turnaround

The Japanese economy is now experiencing a period of extremely slow growth—a recession, Japanese-style. Domestic demand has been virtually flat since the beginning of the year, with private consumption the major element of weakness. In addition, the housing industry has been in recession, and public-sector spending declined in real terms in the January-June period as the government sought to bring its fiscal deficit under control. The only bright spots have been exports and private investment demand. Net exports, for example, accounted for nearly 90% of the increase in real output during the first two quarters of 1980.

Despite the recent relaxation of monetary policy, current evidence suggests relatively little output growth during the next two quarters. Most of last summer's rise in producers' inventories remains to be worked off. Residential construction is likely to remain weak. And export growth is slowing in volume terms. Countering these tendencies will be some continued strength in private investment in plant and equipment—which seems more oriented to modernization and energy conservation than to capacity expansion—a temporary acceleration in public-works expenditures, and a modest recovery in the growth of personal consumption as the rate of consumer price inflation falls below the growth of personal disposable income.

The Japanese current-account balance
(monthly, $ billion)



Partly because of this growth slowdown, Japan's balance of payments has made a remarkable turnaround. Since the first quarter of the year, the trade balance has shifted from significant deficit to comfortable surplus. In the process, the huge deficit on current account has largely been eliminated. Indeed, the recent data on licensed exports and approved imports suggest that the fourth-quarter trade surplus (unadjusted for seasonal variation) may be large enough to bring the fourth-quarter current account close to balance.

The balance-of-payments outlook for 1981 is clouded by uncertainties as to the price of oil and political resistance in Europe and the United States to the continued growth of Japanese exports. But two positive factors should be kept in mind. First, much of the recent reduction in imports reflects the success of oil conservation measures—and, hence, is permanent. Second, if the yen continues to strengthen, dollar-based Japanese export prices are likely to increase fairly rapidly. Thus, even if export volume should prove sluggish, the dollar value of Japanese exports could show healthy growth for some time.

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Austrian economy weakens in response to slowdowns abroad.

After a strong first half, the Austrian economy is beginning to soften in the face of the European—and especially German—recession. Industrial production appears to have peaked around midyear, with the July index just 1.2% above its year-earlier level. Inflation has also eased somewhat; the year-over-year rate in September was 6.9%, versus 7.3% in August. And the January-August current-account deficit was 28 billion schillings, compared with 10.4 billion schillings in the similar period in 1979, confirming forecasts of a 42-billion schilling deficit for all of 1980. Finance Minister Androsch's 1981 budget proposals call for mild fiscal tightening to narrow the payments gap. But the more significant influences on Austria's external accounts and overall economic performance will be the strength and duration of Germany's recession and the timing of a significant easing of German monetary policy.

Finnish economy will record highest European growth rate this year.

Finland's economy continues in high gear and should see real GDP growth of more than 6% this year, the highest in Europe. The economy, however, is showing signs of strain. Unemployment has fallen and many sectors have reached full capacity. Furthermore, inflation has accelerated to break the 11% level, and the balance of trade has deteriorated. A 5.1-billion markkaa deficit was recorded for the first nine months of the year, compared with a 50-million markkaa surplus for the same period in 1979. In response, the four-party coalition government has agreed to a mildly restrictive budget involving an 11% indexation of income tax scales and holding total government expenditures to about 56 billion markkaa, compared with the 43 billion markkaa spent in 1979.

Mexican economic activity slows from feverish to brisk.

Mexican economic activity continues brisk, but the pace of growth has slowed from last year. Industrial production through May was 6.5% above the year-earlier level, which represents a large decline from the almost 11% increase between 1978 and 1979. (Manufacturing, for example, is up only 3%-5% this year, although the oil sector is expanding at rates approximating 20%.) Slowdown is evident on other fronts. Retail sales were up only 3% in real terms in the first half, versus nearly 14% in 1979, and construction is also slightly below the first-half 1979 pace. Largely responsible for the apparent slowdown are the resultant strains and bottlenecks in many sectors as demand outstrips domestic supply. Such constraints raised imports in the first eight months of 1980 by 56% and pushed the rise in wholesale prices to 26% in August. These influences, together with anticipated weakness in agricultural output, point to a real GDP growth rate of 7% in 1980, below last year's 8%, and with higher inflation.

New Zealand's trade surplus is narrowing.

New Zealand's trade surplus for the 12 months ended August declined to $766 million from $794 million in the year-earlier period. A 16.8% rise in export receipts, mostly for wool and dairy and forest products, was eclipsed by a 21.1% increase in import payments, related mainly to more costly oil and refined products. Export prospects for the next 12 months are mixed. Although wool and dairy product prices are likely to decline, export prices for beef and lamb are expected to rise. However, sales of lamb to Iran and Iraq may not materialize because of the continuing Middle East conflict. The recent agreements with the EEC on butter and sheepmeat cut the volume of such exports, but may result in increased revenue for farmers because EEC tariffs have also been reduced. Finally, the monetary authorities have been allowing the NZ dollar to fall steadily against a trade-weighted currency basket, and, if continued, this should help maintain export competitiveness.

New Turkish government continues policy of austerity.

Turkey's new military government has vowed to maintain the austere economic policies of the previous government. To this end, the chief economic strategist of the former government, Turgut Ozal, has been retained. Results of the new policies instituted early this year are mixed. The rate of increase in wholesale prices has eased more quickly than expected. Monthly rates are now less than 3%, bringing the year-over-year wholesale price inflation rate down from 133% in February to 100% in August. Export earnings, however, rose only 7.7% in dollar terms in the first half, and workers' remittances—a major source of foreign-exchange—are actually running below 1979 levels. Imports in dollar terms rose by 17% during the same period, well below earlier official forecasts, probably reflecting problems in obtaining foreign financing. With greater amounts of external finance available in the second half of 1980, imports since June are likely to accelerate. And even with continued economic austerity, Turkey will still need at least $3 billion in new foreign capital next year.

Hong Kong economic growth will be unusually brisk in 1980.

It now appears that Hong Kong will achieve 10% real GDP growth in 1980, a remarkable feat for an export-oriented economy whose major trading partners are experiencing varying degrees of economic recession. The leading sectors have been financial and entrepot services, where rapid growth has been largely fueled by China's modernization drive. The faster growth has stimulated imports, which will cause the trade gap to expand to about $3 billion this year and which has already put considerable pressure on the HK dollar exchange rate. The higher prices for imports are largely responsible for the current 15% rate of inflation. The outlook is for a continuation of double-digit economic growth into 1981 but with some relief possible for inflation. The HK dollar is expected to exhibit greater strength next year owing to heavier capital inflows and an improved trade balance. Consequently, the rate of inflation in 1981 is expected to fall below 10%.

Egyptian external accounts show marked improvement.

Egypt's external-account performance has improved substantially since 1978. In that year, Egypt recorded a current-account shortfall of $1.2 billion and an overall payments deficit of $1.1 billion. The latter was financed by foreign aid, including official grants and loans from Arab and Western governments. In 1979, exports of goods and services rose by 21½% to $6.6 billion, led by petroleum earnings and an increase in workers' remittances. Nevertheless, imports of goods and services expanded at a faster 22% pace to $8.2 billion, widening the 1979 current-account gap to $1.6 billion. The overall balance of payments, however, showed a marked turnaround last year, posting a surplus of $28 million, despite a sharp decline in financial aid from Arab governments. The improvement can be traced to a marked expansion in the inflow of foreign direct investment, as well as to foreign aid commitments from Western governments and institutions totaling $2 billion. Egypt's external accounts will show further substantial improvement in 1980 for two reasons. First, the country's trade deficit will probably narrow somewhat, given the strong likelihood of an expansion in all categories of Egypt's principal exports of goods and services. Second, aid commitments from the West have risen to about $2.5 billion, and the rate of disbursement appears to have picked up. As a result of these developments, international reserves have risen steadily since the end of 1979, reaching a record $1 billion as of mid-1980.

Sugar prices seen holding high as stocks are drawn down.

Sugar prices appear likely to sustain their current strength over coming months. Although early projections of 1980-81 production suggest some increase in output, the outlook remains clouded. And this does little to ease the speculative forces that have in recent months pushed sugar prices to their highest level in five years. In October, the International Sugar Agreement world price for raw sugar averaged more than 40¢ per pound—about double the price last February. With the 1979-80 growing season hurt by uneven weather, strikes, and disease-plagued cane fields, sugar production fell to 85.4 million metric tons—down 5½% from output in the previous year. At the same time, sugar consumption continued its strong and steady rise, totaling 91 million tons last season and necessitating a worldwide stock drawdown of some 5.6 million tons. Although current high prices may work to moderate consumption, additional reductions in stocks over the coming year are still anticipated. In the past, high sugar prices have coaxed increased production, sometimes causing the market to overreact and produce a worldwide glut, which in turn sent prices plummeting. This year, high oil prices have made ethanol production an attractive alternative for some sugar cane growers. Consequently, it is unclear how high sugar prices must rise to shift output back to production for human consumption.

State and Local Governments Expand Debt

Over the last year and a half, state and local governments have been going deeper and deeper into debt. On a national-income-accounts basis, the operating budgets of state and local governments have accumulated about $22 billion of deficits since early 1979. And heavy borrowings are coming at a time when interest rates on municipal issues are at record levels.

In some respects, the pattern is a replay of what occurred in the 1973-75 recession. A softening of economic activity caused tax receipts to slow or fall, especially revenues from personal and corporate income taxes and sales taxes. And the federal government cut back on its grants to state and local governments. At the same time, rising unemployment kept pressure on local spending for job programs and transfer payments. The result was that deficits mounted.

Even in good times, state and local governments must borrow. Their income flow, much like a household or business, is seasonally uneven (depending on tax dates, for example). Consequently, they must borrow short term to ensure a more uniform cash flow that matches their steadier pattern of expenditures. And they borrow long term to finance capital construction or durable equipment purchases, or to refinance existing debt.

In 1977, state and local governments had gross new debt issues of $71.5 billion. As the recovery continued, borrowing fell to $69.7 billion in 1978 and to an annual rate of less than $60 billion in the first quarter of 1979. But the shift into a deficit position helped push borrowing to an annual rate of about $67 billion for the remainder of 1979. New debt issues have surged to an annual rate of $78 billion during the first eight months of 1980, with some $7 billion of this representing borrowing to bolster the mortgage market.

Although the economic slump has led some state and local governments to borrow larger sums, they still seek to minimize the cost of borrowing, especially in the bond markets where there is more discretion as to timing. When municipal bond rates soared to their then-record levels in the first quarter of 1980, the pace of long-term borrowings slowed to about 75% of the pace in the first quarter of 1979. But as bond rates plunged in the spring, long-term borrowings jumped 40% above their year-earlier level. Municipal bond rates have now risen above last winter's peaks, and state and local governments have shifted more toward short-term borrowing. But rapidly rising short-term interest rates since the summer have made this choice costly as well.

Unless spending growth can be substantially trimmed, or unless Congress limits mortgage-related borrowings, the prospect is for continuing deficits and increased borrowing in 1981. A sluggish economic recovery offers little hope of any fundamental improvement in the outlook for tax receipts. And pressures on the federal deficit preclude much, if any, added assistance coming from Washington.

New Reserve Rules Complicate Fed Policy

The phase-in of bank reserve-requirement changes beginning this month should make it more difficult for the Federal Reserve to manage reserves in a manner consistent with its monetary objectives in the near term. It should also make it more difficult for money-market participants to interpret the significance of open market operations and of reserves statistics in coming weeks.

In keeping with the provisions of the Monetary Control Act of 1980, new reserve requirements are being phased in this month. Beginning with the week ending November 19, some commercial banks and thrift institutions that are not members of the Federal Reserve System will be required to hold reserves against certain deposit balances that were on their books two weeks earlier. The reserve-requirement schedules for member banks will also change, with reserve requirements falling, on balance.

One stated purpose of this Act is to enhance the ability of the Federal Reserve to control the money supply by extending reserve requirements on deposits to all depository institutions. These reserve-requirement changes will be phased in over an eight-year period. However, the phase-in process initially complicates the implementation of monetary policy.

The reserve-requirement changes will cause significant movements in the weekly reserves measures. Total required reserves are estimated to fall by about $3 billion, while excess reserves at nonmember institutions are expected to jump by more than $3 billion. (The reason for the latter estimate is that many of the smaller of these institutions hold substantial amounts of vault cash that will exceed their initial reserve requirements.)

Such estimates, however, are subject to significant uncertainty. Consequently, interpreting the motivation for open market operations—i.e., Fed transactions in U.S. securities that affect reserves—in the coming weeks will be more difficult than recently.

Moreover, estimates of these measures will continue subject to greater uncertainty in future weeks. This is especially true for the excess-reserves measure, since there is little evidence of how the demand for excess reserves of nonmember institutions fluctuates over time, or how sensitive it is to interest-rate changes.

Consequently, the Federal Reserve's task of estimating a target for nonborrowed reserves (required plus excess reserves less bank borrowings from the Fed discount window) that is consistent with its monetary growth objectives will be more difficult than usual in coming weeks. This increases the likelihood that the Fed may focus more on the behavior of the federal funds rate in conducting monetary policy in the near term. This would not mean, of course, that the funds rate will be stable. It would imply, however, that open market operations would be designed to a greater extent to limit fluctuations in the funds rate arising from unanticipated shifts in the demand for reserves.

Africa and Middle East Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1978		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	12-month changes consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars November 5, 1980	change from year earlier	current monetary conditions	
Algeria	Development plan for 1980-84 to be approved later this year; investment target set at $104 billion.	June	+ 59%	24.6	$ 1,374	Sept.	3,798	+ 52%	5.6	0	U.S. and Algeria fail to agree on El Paso LNG import price.	June '79	+ 14%	Dec.	+ 15%	.2640	+ 1%	Credit generally available.	Algeria
Cameroon	Budget for fiscal 1980/81 includes substantially higher levels of investment spending.	Mar.	+ 67%	4.0	500	May	199	+ 91%	1.7	18	Sharp rise in oil output boosts trade account.	June	+ 12%	Apr.	+ 27%	.00465	− 3%	Rapidly rising foreign-exchange reserves enhance liquidity.	Cameroon
Egypt	Economic reforms planned for public sector, customs service, tax law, and foreign investment.	June	+ 74%	16.4*	400	July	1,079	+221%	3.0	249	Oil output averaging 600,000 bpd, up 14% from 1979.	June	+ 25%	June	+ 17%	1.4300	0	Money supply expanding rapidly.	Egypt
Gambia	Smallest groundnut crop in 12 years triggers 19% drop in FY 1979/80 real GDP.	July	− 41%	0.1	182	Sept.	10	+182%	0.3	9	Sharply higher trade deficit reflects one-third higher import costs.	July	+ 4%	June	− 3%	.6150	+15%	Money supply contracts.	Gambia
Ivory Coast	Poor rains expected to reduce 1980/81 cocoa crop 8% below last year's 360,000-ton bumper.	Jan.	0	7.6	1,440	June	23	− 91%	0.1	0	Domestic oil output could save an estimated 30% of 1981 oil costs.	July	+ 10%	Mar.	+ 3%	.00465	− 3%	IMF-backed austerity program restricts liquidity.	Ivory Coast
Kenya	High oil import costs curtail supply of development funds; business remains pessimistic.	Apr.	+ 39%	6.0*	400	Sept.	452	− 26%	2.6	135	Sagging tea and coffee prices and weak tourism restrict fx earnings.	Aug.	+ 14%	May	+ 18%	.1400	+ 5%	Interest rates rise to stimulate savings.	Kenya
Morocco	September reduction of subsidies for basic food commodities aimed at reducing budget deficit.	Mar.	+ 52%	15.3*	788	Aug.	166	− 65%	0.9	165	Price of phosphate rock exports resumed upward trend in August.	June	+ 10%	June	+ 16%	.2470	− 5%	IMF approves three-year credit facility for SDR 810 million.	Morocco
Nigeria	Apart from buoyant oil sector, economic performance is disappointing.	June	+ 70%	50.7*	625	Aug.	9,249	+127%	9.5	0	Recent cutbacks suggest oil output of 1.95 million barrels daily in 1980.	Dec.	+ 12%	May	+ 17%	1.9380	+12%	Foreign-exchange inflows expand liquidity.	Nigeria
South Africa	Acceleration in economic activity has yet to produce signs of overheating.	July	+ 45%	57.3*	2,070	Sept.	1,225	+ 50%	0.8	0	This year's $4-billion current-account surplus likely to evaporate in 1981.	Aug.	+ 12%	June	+ 27%	1.3330	+10%	Liquidity continues excessive.	South Africa
Tanzania	Rise in producer prices should boost 1981/82 food output.	Dec.	+ 9%	4.6*	267	Aug.	48	− 25%	0.5	10	Poor export outlook threatens to widen last year's $575-million trade gap.	Mar.	+ 21%	Dec.	+ 51%	.1229	+ 2%	IMF makes $255 million available over two-year period.	Tanzania
Zambia	Production problems cut copper output 28% to 506,000 tons for year to June.	Nov. '79	+ 22%	3.2*	572	Aug.	65	− 17%	1.3	445	Weak markets for copper and cobalt reduce foreign-exchange earnings.	Mar.	+ 11%	June	+ 19%	1.3200	+ 6%	Increase in liabilities widens net foreign asset gap.	Zambia
Zaire	Economic contraction reported to be arrested; rate of inflation slows.	Dec.	+279%	6.4	230	Aug.	178	− 15%	3.3	271	Rescheduled debt payments being met; further rescheduling set for 1981.	June	+ 50%	Apr.	+ 19%	.3530	−28%	Business loans show substantial rise.	Zaire
Tunisia	Industrial output expansion slows from 1979 pace.	Mar.	+ 53%	7.0*	1,096	Sept.	709	+ 43%	3.1	0	Phosphate output in first half was 2.4 million tons, 51% above year earlier.	July	+ 10%	May	+ 10%	2.5100	+ 1%	Saudi/Tunisian investment company to be set up.	Tunisia
Jordan	Japan's Overseas Economic Cooperation Fund lends $40 million for telephone network.	Mar.	+ 37%	2.8*	917	Sept.	1,231	+ 10%	7.1	0	Phosphate exports through August up 41% from year-earlier period.	July	+ 14%	June	+ 28%	3.3800	+ 2%	Euroloan of $150 million signed in late September.	Jordan
Kuwait	New five-year plan beginning 1981/82 includes development-project allocation of $11.2 billion.	June	+ 5%	23.3**	18,330	Sept.	3,302†	+ 25%	7.8	0	Oil export boost of 350-400,000 bpd planned for fourth quarter.	Dec.	+ 6%	June	+ 28%‡	3.7106	+ 3%	Rising dollar rates and Gulf War spur heavier capital outflow.	Kuwait
Qatar	Imported food prices in state-controlled shops to be heavily subsidized.	June	+ 53%	4.5	22,500	Mar.	328†	n.a.	3.3	0	Rise in crude oil exports of 20,000 bpd reported.	n.a.	—	Mar.	+ 24%‡	.2748	+ 3%	Bank credit to private sector rising steadily.	Qatar
Saudi Arabia	Several contracts awarded for projects in petrochemicals, infrastructure, and desalination.	June	+ 94%	74.8	11,510	Sept.	23,896†	+ 35%	9.0	0	Oil output reportedly 10 million bpd, vs. 10.4 million in first-half October.	Mar.	+ 2%	May	+ 48%‡	.3011	+ 1%	Money supply rising rapidly.	Saudi Arabia
United Arab Emirates	Private-sector economic activity continues to expand steadily.	June	+ 58%	13.8	19,435	Sept.	2,230†	+128%	3.8	0	Abu Dhabi oil export price raised $2 per barrel.	n.a.	—	June	+ 1%	.2711	+ 3%	UAE cabinet to set up a specialized real estate bank.	United Arab Emirates

*1979 **FY 1979/80 †Excluding state reserves ‡Private sector only

World Interest Rates

market rates of Nov. 5, 1980; bond yields as of Oct. 31, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	11.00	12.16	16.00	12.00	9.50	7.50	16.50 penalty rate 19.50	8.00	3.00	7.25
Day-to-Day Money	15.00 Nov. 6	11.50	15.50	12.00	19.75	9.10	17.75	9.00	5.25	10.8125
Treasury Bills 91-day, Middle Rates	13.44	12.55	14.625	12.10	n. a.	n. a.	15.699 87-day	no dealing	no market	6.375 2-month
Commercial Paper prime, 3-month, asked	13.25 finance paper	12.60 finance paper 15% tax w/h	14.4385	11.60 Certified	11.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	14.20	12.50 15% tax w/h	15.75	11.60 Certified	not traded	9.90	n. a.	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	12.11	13.25	12.92	10.61 20% tax w/h	13.435	8.57	21.35	10.32	4.69	8.452
Industrial Bonds prime, long-term, new and old issues, average yield	12.95 Aa Industrials	13.875	13.61	14.774	14.57	8.73	16.06	10.24	5.784	7.20
Bank Short-Term Rate to Best Borrowers (prime rate)	15.50 Nov. 6	13.25	17.50	15.75	13.85	11.50	16.23 ⅛ qtrly. fee on outstdng.	11.00	5.50	8.50
Bank Time Deposits 3-month	14.625 Cert. of Dep.	n. a.	16.50	12.25	11.375	9.20	21.00	9.375 large deposits	5.25 residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	15.9375	no market	17.25	no market	11.50	9.25	no market	9.375	5.375	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8590	2.4460	.03216	.2238	.5152	.001197	.4770	.5745	.004743
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	3.625 *P*	1.00 *D*	3.50 *P*	4.50 *P*	6.625 *P*	9.625 *D*	6.375 *P*	10.375 *P*	5.75 *P*

Eurodollar Deposits
(London, interbank, bid)

Nov. 5	
7-day	14.50
1-month	14.4375
3-month	15.8125
6-month	15.6875

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	+ .016
U.S.-Canada Treasury Bills	−2.17
U.S.-Canada Finance Co. Paper	−2.80
Eurodollars-U.K. Local Auth. Deposits	+ .9375

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	13.375
Over 7 yrs.	13.50
DM Bonds	
7 yrs. and under	6.375
Over 7 yrs.	6.50

Gold Price

London afternoon fixing

652.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Maturity Distribution of Chinese Commercial Debt

(million $)

	End-1977	Mid-1978	End-1978	Mid-1979	End-1979
Claims on BIS Banks	2,481	3,177	2,440	3,538	2,662
Liabilities to BIS Banks	455	891	992	3,141	2,456
Up to 1 year	390	647	780	2,695	1,292
1-2 years	7	11	5	7	37
More than 2 years	55	35	26	289	961
Unallocated	3	198	181	150	166
Undisbursed Credit Commitments	449	520	1,224	2,642	3,839

Source: Bank for International Settlements

China Streamlines its Development Strategy

China's recent National People's Congress, which concluded in September, marked a political and economic turning point. The resignation of Hua Guofeng and Deng Xiaoping from their government positions and the promotion to prime minister of a younger technocrat, Zhao Ziyang, set a precedent for peaceful succession and future political stability. On the economic front, the Congress explicitly abandoned the ambitious ten-year development plan unveiled in March 1978 and underscored the more gradual, but balanced, economic strategy of the past year.

The more conservative approach to economic development was introduced in 1979 with a three-year plan of "readjustment and consolidation" for the 1979-81 period. The new strategy shifts priority from heavy industry to light industry, agriculture, electric power generation, and transportation. The new realism acknowledges the limits on China's absorptive capacity—its technical and managerial expertise as well as its basic infrastructure—and seeks to generate needed foreign exchange over the nearer term.

Given political stability and more realistic growth targets, China should achieve average annual national income growth of 5%-6% between 1980 and 1985. The country's basic advantages include plentiful supplies of energy and raw materials, a large and motivated work force, and sufficient financial resources. The average growth rate for industrial production during the 1980-85 period is expected to be 7%-8%, somewhat lower than it would have been under the earlier ten-year plan. After the remarkable gains of 1978-79, agricultural growth will probably average only about 2½%, but foreign trade volume through 1985 could expand by 7%-9%, on an average annual basis. Imports, which should climb rapidly for several more years, will consist mainly of grain and capital equipment, while export growth will be stimulated by increased volumes of light manufactures and higher world energy prices. Oil export prospects have been revised downward, given current limits on production and delays expected in developing offshore reserves.

China's economic growth prospects for the 1980s have been strengthened in recent years by several important organizational developments. A tilt toward economic pragmatism has been indicated by the government's efforts to foster freer markets and greater enterprise autonomy. Following the experiments introduced in Sichuan by Zhao Ziyang, state-owned enterprises have been given more decisionmaking authority and permitted to retain a portion of their profits. In addition, orthodox banking practices are being restored—with more economic transactions being shifted from budgetary to financial channels—and the Chinese legal framework has developed rapidly to accommodate commercial contracts and joint ventures with foreign firms. The authorities have also acknowledged the critical need to enhance the quality of management techniques to accompany the gradual decentralization of economic activity. To improve economic planning and macroeconomic policy in the 1980s, improvements are needed in collecting and processing economic information. For the first time since 1959, comprehensive data for the 1977-80 period have been published by the State Statistical Bureau.

Recent economic performance

Reflecting the leadership's new policies, the rate of growth of China's heavy industry slowed markedly in 1979 from the more feverish pace of 1977-78. Total capital investment grew only 4.4% in 1979, after having increased 31.3% the year before. Agricultural output rose sharply in 1978 and 1979, with a record grain harvest of 332 million metric tons and a 24% increase in meat production in 1979.

China's total exports reached $13.7 billion last year, up 37% from 1978. The strong export showing was the result of the sharp rise in oil and basic commodity prices, as well as buoyant demand for Chinese manufactured goods (including textiles, handicrafts, and food). The value of imports (f.o.b.), however, rose even more sharply to $14.5 billion, up 41% over 1978, owing to record imports of grain (despite the good harvest), steel, and machinery. Thus, a global trade deficit of less than $1 billion is estimated for 1979. Trade with other Communist countries rose much less rapidly in 1979 and may have actually declined in real terms. Overall, real national income is estimated to have grown 7%, a steep deceleration from the 12% rise posted in 1978.

Recently, industrial performance has turned up once again. In the final quarter of 1979 through the first half of 1980, industrial growth surged. The upturn has been concentrated in light industry, textiles, chemical fertilizers, and electricity generation. Stimulated by the strong harvest of 1979 and by decentralization, output of light industry and of textiles grew 24.4% and 28.8%, respectively, above first-half 1978. Electric power generation grew nearly 10% above 1979 levels, with faster growth in hydroelectric power and improved performance in coal-powered generation. The rise in chemical-fertilizer production —22.6% higher than first-half 1978 output—was partly the result of the completion of new phosphate plants. On the agricultural front, the 1980 harvest is unlikely to repeat last year's record showing; a drought in the northeastern region is expected to trim the wheat harvest by more than 6% and reduce output of several other crops. Overall, Chinese national income is pro-

jected to grow 6.5% during 1980.

China's trade deficit is expected to increase slightly to around $1.5 billion in 1980. Windfall gains from world oil prices in the first half have boosted export earnings sharply. (Some eight million tons of crude are expected to be exported to Japan this year; the average per-barrel price paid by the Japanese in the first half was $33.) Export volumes of hard coal and coking coal, also mainly to Japan, have climbed more steeply. In contrast, Chinese imports of machinery and steel products in the first half rose only by 10%-15%, and grain imports are projected to exceed 12 million metric tons for the 1980/81 marketing year, an increase of 20% from the previous year. In October, a four-year U.S.-China grain agreement was signed. This assures the Chinese 6-9 million tons of U.S. grain annually and supplements earlier long-term agreements signed with Canada, Argentina, and France.

China has also moved quickly to obtain Western and Japanese technology. Even where no equipment exports are involved, foreign firms are paid for engineering design, licenses for technology, and training of personnel. The wooing of foreign technology has gained in importance over the past year. The 1979 collapse of a domestically produced offshore oil rig in the Bohai Gulf underscored bureaucratic malfeasance and indicated that Western technology was essential for offshore petroleum development. In addition, the Baoshan metallurgical complex, a key project of the earlier 10-year plan involving heavy import content, is already a disappointment. Problems here have been attributed to Chinese planning failures, however, and not to any deficiencies in imported technology and equipment.

Although China's petroleum industry will record near-zero output growth this year, it holds the greatest promise for reasonable balance of the country's external accounts when offshore reserves are brought into production later in the decade. Petroleum will also be the lynchpin of China's developing relations with both Japan and the United States. China has contracted with Japanese, U.S., and British firms for offshore exploratory drilling and has invited bids from Western firms to develop offshore oil and gas reserves. Agreements have been signed with Japanese and French concerns to exploit reserves in the Bohai and Beibu Gulfs, under joint-investment and risk-sharing arrangements. And American oil firms are expected to assume a major role in developing the oil potential of South China Sea fields. Output from existing onshore fields is expected to begin declining by 1982, which lends some urgency to the development of offshore fields.

External debt will rise, but cautiously

China has had little problem in obtaining plentiful supplies of external credit, largely because of its sound financial condition and low external debt level. At the beginning of 1980, gross external debt was around $4 billion, hard currency reserves exceeded $2.5 billion, with gold reserves estimated at 500 tons. The Bank of China has sought to supplement its resources with short-term commercial credits, long-term official (export) credits, and development loans from the United Nations and Japan. During 1979, China's external liabilities to commercial banks rose nearly $1.5 billion, roughly two-thirds of which was in the form of medium and long-term credits. At the same time, undisbursed credit commitments grew by $2.6 billion (see bottom page 6).

China's borrowing strategy is aimed at maintaining financial flexibility as external obligations rise during the current decade. It now appears, however, that further rises in external indebtedness will be more gradual than abrupt. More recently, the Chinese have been reluctant to borrow in Western capital markets with nominal interest rates so high. As China's absorptive capacity increases, the net capital flow from abroad might reach the $3-$4-billion level long hoped for by Japanese and Western business. China's IMF quota was recently raised to SDR 1.2 billion, and most observers expect the new member to play an active role in both the IMF and the World Bank.

A rapid expansion in China's economic relations with the West depends upon many factors. The first and foremost is China's political stability and its commitment to economic cooperation with other nations, conditions that have generally been met since the death of Mao Zedong. Indeed, there appears to be a general consensus among Western observers that political stability has increased significantly in recent years. Consequently, the announced priorities of economic growth and modernization have a more secure political foundation than in any other period since the 1950s. Macroeconomic performance and the standard of living have shown clear improvement, which has boosted worker productivity and morale. And the recent revision of economic priorities should sustain domestic financial equilibrium. Political controls, however, have tightened and may be strengthened further to sustain political stability.

In sum, China's long-run growth prospects are impressive, largely because of fundamental internal economic and structural advances. Moreover, these domestic developments have been reinforced by international events that have worked to China's advantage, such as the OPEC oil price shock of 1979-80 and the Soviet invasion of Afghanistan. *Donald W. Green*